Americas CIO View

Neither higher wages, oil, nor federal funds rates threaten margins

Strong 1Q earnings season is under-appreciated: S&P 16.5x this year's likely EPS

The 1Q earnings season is very strong on both a beats and growth perspective. 87% of the S&P 500 by earnings weight has reported. The weighted average earnings-per-share (EPS) beat is 7.6%, which compares to the 3.4% average beat since 2011. Every sector reported better results than expected. Bottom-up 1Q EPS is up 24.9% year over year (y/y), which compares to average EPS growth of 7.5% since 2011. Even excluding the tax benefit (8-9%), 1Q EPS growth is still excellent. However, the market appears unenthusiastic as the S&P is down since the beginning of reporting. Many possible reasons are quoted such as macro data softening from high levels, the end of analysts' earnings upgrade cycle, peak-margin worries, looming inflation and interest-rate-surge concerns, uncertainty on Fed hikes beyond 2018, trade-tariff threats, etc. In our view, most of these concerns are exaggerated and unlikely to materialize into real threats. We are optimistic on U.S. equities and our "next 5%+" S&P 500 tactical call remains "Up".

S&P 1Q EPS up 24.9% y/y: pretax income 14.9% y/y, 8-9% tax benefit, 1-2% buyback

We think analysts were reluctant to include the full tax-cut benefit in their 1Q EPS estimates, rather waiting for an indication this earnings season. That's why the overall beat is much higher than many expected. Bottom-up (Btm-up) 1Q EPS is now $38.52, much higher than the $26.00 consensus going into the earnings season, and even slightly above our long-standing $28.00 estimate. 1Q EPS growth is tracking up 24.9% y/y. To break it down, pretax-income growth is 14.9%, given a 1-2% boost from buybacks, the implied tax benefit is 8-9%. If we annualize 1Q EPS, it's $154. We see upside to our 2018 whole-year EPS estimate of $155. It's more likely to be close to $160 if Fed hikes 2 more times, oil stays ~$65 and dollar doesn't surge from here.

S&P net margins are cyclical, but not mean reverting

In 2012, the S&P 500 net margin reached the previous cycle high of 9.3% in 2007. Ever since, many have voiced worries of margins being unsustainable. Our long-held view is that the S&P net-margin expansion since the mid-1990s is sustainable for many structural reasons: (1) S&P constituent changes (~5% annual constituent turnover); (2) lower effective tax rates as S&P foreign profits doubled since the mid-1990s, and now a lower U.S. statutory corporate tax rate; (3) less net debt and lower interest rates reduce interest expense; (4) higher-margin businesses expanded abroad causing higher margin sectors and industries to be a bigger share of S&P earnings. It's also important to realize that despite the S&P's rising net margin since the mid-1990s its aggregate ROE remains in line.

David Bianco
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In a nutshell

- Strong 1Q earnings season is under-appreciated: S&P 16.5x this year's likely EPS
- S&P 1Q EPS up 24.9% y/y: pretax income 14.9% y/y, 8-9% tax benefit, 1-2% buyback
- S&P net margins are cyclical, but not mean reverting
- S&P margin will fall upon next recession, but rising wages, oil, Fed hikes won't hurt it
- We think a 10- to 15-year economic expansion is quite possible

Source: Thomson Reuters I/B/E/S Estimates, Deutsche Investment Management Americas, Inc. as of 5/4/18

Theory supports return-on-capital mean reversion, not margins. Since 2012, the S&P net margin set a new record every year except for 2016, due to the crash in Energy profits. On current constituents, the S&P's pro-forma net margin was 11.0% in 2017. Now with the new 21% U.S. corporate tax rate, 1Q18 btm-up S&P net margin rose to 12.3%.

S&P margin will fall upon next recession, but rising wages, oil, Fed hikes won't hurt it

Both S&P net margins and the U.S. unemployment rate are very cyclical. Historically, S&P net margins are near their peak just before the start of a recession and unemployment near its low. This peak in margins and trough in unemployment are only clear in hindsight after a recession starts. Past recessions have come with very different margin peaks and unemployment troughs at the start. S&P net margins normally rise when average hourly earnings rise, which is largely due to higher employee productivity that occurs when businesses get to higher capacity utilization of fixed assets and other economies of scale. It is unit labor costs (ULCs) that are a better indicator of margin pressures, and right now ULCs are benign. ULCs are a better measure of broad-based inflation and currently remain below Fed's 2% target being up only 1.1% in 1Q18. We don't think wage growth will hurt S&P margins unless ULCs rise significantly above 2% y/y.

Higher oil and commodity prices usually benefit S&P net margins as the S&P is more a commodity producer than consumer. Also Fed hikes, especially early-cycle hikes occurring when the overnight rate is still below the neutral rate, are normally accompanied by rising S&P margins. We think the S&P's net margin will remain at current levels until the next recession.

We think a 10- to 15-year economic expansion is quite possible

Australia has taken the record for the longest economic expansion at 26 years since 1992. We also note that the UK, a mature service-consumption-driven economy like the United States, had a 16-year expansion from 1992 to 2008. Although this current U.S. expansion is 9 years old and the U.S. record is 10 years from 1991 to 2001, we see no good reason for a recession anytime soon. Even if growth is slow in the coming years, the U.S. economy should be resistant to shocks owing to its lesser sensitivity to inventory, capex and credit cycles. The U.S. is less dependent on foreign oil and thus less susceptible to geopolitical shocks. The Fed will have room to cut rates from the 2.5%+ level likely in the coming years and the Fed does have other tools to stimulate if inflation is not a threat. The external threats to the U.S. appear benign given economic conditions globally, particularly given the respectable growth in Europe and Japan and the soft landing China has engineered in its curtailment of credit-driven investment spending.

Source: Thomson Reuters I/B/E/S Estimates, Deutsche Investment Management Americas, Inc. as of 5/4/18

Glossary

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Margin

Margin describes borrowed money that is used to purchase securities.

Return on equity (ROE)

The Return on equity (ROE) is the amount of net income returned as a percentage of shareholders‘ equity.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Unit labor costs

Unit labor costs (ULC) measure the average cost of labor per unit of output.

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